THE FUTURE OF THE INDIVIDUAL INCOME TAX*

Delivered to the Annual Symposium
National Tax Association/Tax Institute of America
Washington, D.C.
May 17, 1982

Joseph J. Minarik
Deputy Assistant Director
Tax Analysis Division
Congressional Budget Office

* Valerie Amerkhail, James Nason, Kathleen O'Connell, Nancy O'Hara, Joseph Pechman, Pearl Richardson, Hy Sanders, Martha Smith, Emil Sunley, and James Verdier provided helpful comments on drafts of this paper. William Sutton and Xe Nguyen kindly advised on and executed the simulations in Table 1. Shirley Hornbuckle typed the manuscript. Responsibility for opinions and any errors is the author's alone and should not be attributed to the Congressional Budget Office or any of the above named individuals.

J932-58

The first thing we realize as we look toward the future of the individual income tax is that we stand at a most unusual vantage point. The Economic Recovery Tax Act of 1981 (ERTA) was unprecedented. It was the largest tax cut in the history of the Republic, perhaps the largest since the fall of the Roman empire. Nobody seems to know for sure.

The size of the ERTA cuts convinced many tax analysts that there would be no further income tax legislation for some time. The reasoning was that no further tax cut would even be considered, and that no other tax change would be politically feasible without an accompanying tax cut to sweeten the deal. This sense of immutability evaporated as the long-term implications of ERTA became clear. The fear of ever increasing budget deficits, even with the Administration's proposed 1983 budget cuts, has galvanized the will of the Congress to do something that it has always hesitated to do: raise taxes.

Will the individual income tax be changed in a long-run budget realignment? The size of the looming budget deficits (exceeding $200 billion per year by fiscal 1985 on a current policy basis) strongly suggests that there must be substantial changes in both outlays and revenues. On the revenue side, the individual income tax seems to be a prime target for at least two reasons: First, it is the largest current source of revenue, and thus would require the smallest proportional increase of any existing tax to yield a given revenue increase; and second, it was just cut substantially, and so some partial backtracking might not be too painful. To these two reasons some tax experts might

add the shortcomings of the current individual income tax, and the chance that a revenue raising bill might improve the tax system.

Though our individual income tax is generally acknowledged to be the most successful tax in the world by any criteria, complaints (perhaps caused in part by our high standards) would surprise no one in this room. The complaints can be summarized as follows: The tax system is too complicated; inflation distorts the intended effects of the system, particularly with respect to income from capital; and the mass of special features in the code diverts resources from productive activity toward tax gamesmanship, provides windfalls to those who can manipulate their affairs to take advantage, and requires high marginal tax rates that choke off work, saving, and investment. It may be fairly easy for us to agree on such an indictment of the income tax, but agreeing on a solution would be far more difficult. Therein lies the heart of the following discussion: How might we increase federal revenues and come closer to our goals of efficiency, simplicity, and fairness for the individual income tax?

AN EXPENDITURE TAX?

One alternative to the current individual income tax is a progressive expenditure tax. The expenditure tax has roots extending back to Kaldor and beyond.[1] The case for the expenditure tax is well developed and well understood, at least among tax economists. Controversy over its merits continues because value judgments, the bane of the social scientist, influence or perhaps dominate the debate.

With David Bradford's presentation to follow immediately, there is no need to compare the income and expenditure taxes in detail; nonetheless, some discussion is essential to the evaluation of the future of the income tax. To reassure the uninitiate, while an expenditure tax would require us to pay a year-end tax on our spendings at the grocery and the five and dime, it would not require that we save all of those cash register tapes under penalty of the stockade. Rather, the expenditure tax would work superficially much like the current income tax.[2] The tax would be withheld out of workers' paychecks, just as it is now. When the expenditure tax return was filed, the same income computation as is made now would be the first step in finding the final tax liability. However, from income would be deducted all saving: the increase in checking and savings account balances, purchases of stocks and bonds, and so on (saving could obviously be negative rather than positive). The tax base would thus be all of income that was not saved (or all of income plus further spending out of prior saving); hence, expenditure.

A tax on expenditure as so defined has numerous properties with respect to fairness that are very attractive to some economists.[3] Some tax experts argue that expenditure is a better measure of what a taxpayer takes out of the economic system than is income, and thus is a more appropriate tax base. Further, the expenditure tax, unlike the income tax, has a coherent interpretation in the context of the taxpayer's entire lifetime. Two taxpayers with equal discounted lifetime incomes and no prior wealth or saving at death will pay equal discounted lifetime

taxes under a proportional expenditure tax. This equal treatment over the lifetime ex ante is an attractive property. Another aspect of the same attribute is the close association of consumption and expected lifetime income, which is an implication of the permanent income hypothesis. Thus taxation of consumption in any given year is likely to be a closer approximation of taxation of lifetime income, which some would argue is the correct tax base, than is taxation of current income.

Against these attractive properties of expenditure taxation must be weighed counterarguments and qualifications.[4] Other tax experts argue that income measures the taxpayer's power to consume, and that income is thus the better tax base. One could question the importance of equal present discounted tax liabilities of equally endowed individuals in a world of rapidly changing fortunes and economic conditions, as well as widely diverging endowments. Further, the assumptions required for this ex ante lifetime equivalence will surely not be borne out in practice, because bequests diverge quite far from zero, and an expenditure tax would certainly not be proportional (in fact, if upper-income households save more of their income, as is thought to be the case, the expenditure tax would need a steeper rate schedule than the income tax to achieve the same progressivity with respect to income). One might further question the wisdom of a tax on consumption as a proxy for permanent income. Such a tax would increase liabilities relative to an otherwise equivalent income tax for the taxpayer's years of lower than trend income, such as youth, old age, and (most significantly) involuntary and unexpected

unemployment. Finally, a tax on the more stable tax base of consumption would be nearly procyclical, compared to the automatic stabilizer effect of the income tax which cushions macroeconomic fluctuations.

A final possible fairness problem is the accumulation of wealth. Wealth accumulated tax free under the expenditure tax could be more easily passed on to succeeding generations (even considering our current estate tax, which was designed to deal with accumulations from income that was already taxed). Concerned economists have advocated taxation of gifts and bequests to the donor as his consumption, periodic wealth taxes, or more stringent estate taxation. The fear is that, absent such taxation, wealth would be saved without tax, accumulate without tax, and then be given to an heir without tax (as a gift, or lightly taxed as a bequest) to accumulate further without tax. Others have argued that taxation of gifts and bequests to the donor, and then again to the donee when consumed, would be double taxation; or that heavier wealth taxation would be a significant disincentive to saving. Of course, the Congress has been extremely tentative in its handling of the taxation of wealth, and sharply cut back estate taxation last year. Virtually nothing definitive can be said in this area. I can only note that the treatment of wealth, gifts, and bequests in an expenditure tax will be extremely controversial; that we know virtually nothing about the effect of wealth taxation on taxpayer behavior in the current context, much less under an expenditure tax; that the choices made could have enormously significant implications for the distribution of wealth; and that the legislative outcome in this area would be highly unpredictable.

A second criterion for comparison of the income and expenditure taxes would be simplicity and ease of administration.[5] Theoretically, the expenditure tax does not require many of the special provisions (or "loopholes," if you prefer) of the income tax. Thus, the expenditure tax might have a cleaner base and be simpler for taxpayers and administrators. Of course, the income tax has no theoretical need for those special provisions either, but they exist nonetheless. Would the expenditure tax in fact have a cleaner base? Perhaps an expenditure tax could be passed while the lobbying interests were caught with their conceptual pants down, not understanding the expenditure tax and thus not prepared to argue their cases effectively. Perhaps starting from a clean slate would encourage the Congress to resist the special pleaders. On the other hand, the forces behind the complexity of the current tax code might seize the opportunity, and convince the Congress to give them more than they already have. One could imagine any number of socially admirable forms of expenditure -- housing, education, medical care, charitable giving, etc. (automobiles?) -- that might be exempted from expenditure taxation by a sympathetic Congress. We could easily exchange a leaky and inefficiency-inducing income tax base for an equally leaky and inefficiency-inducing expenditure tax base.

One special attempt to simplify the expenditure tax is the prepayment concept, pioneered by the Treasury under David Bradford.[6] Under the expenditure tax as previously conceived, taxpayers would be required to report each purchase of an asset (in order to claim the deduction for

saving) as well as each sale (in order to report the receipt of the proceeds). Thus, in comparison to the current income tax, under which only sales need to be reported, the expenditure tax would require twice as much paperwork. Advocates of the prepayment approach reason that investment outcomes are essentially random, and so the Treasury should be indifferent as to whether taxpayers deduct their investments when they make them and pay tax on the proceeds upon sale on the one hand, or forego the deduction upon making the investment and then omit paying tax on the proceeds when the asset is sold, on the other. If all taxpayers declined the deductions for the purchases of investment assets in any given year, and then omitted the sales proceeds from taxable receipts the next year, the Treasury would collect $N of additional taxes in the first year and $N (1 + r) less in the second (where r is the average rate of growth in the economy). There would thus be no revenue consequences for the Treasury in present value terms, neither sales nor purchases of prepaid assets would be taxable events, and the compliance load would be decreased rather than increased relative to the income tax.

The prepayment option is an intriguing approach to simplifying tax administration and compliance. Unfortunately, it has some possibly serious problems.[7] For one thing, tax returns are filed several months after the tax year ends. An investor could make an investment, observe its performance for a year or more, and then file his return electing prepayment or postpayment to his own advantage (and the detriment of the Treasury). This problem could be solved by requiring the taxpayer to

make an immediate election, but that would send millions of pieces of paper floating to the IRS each year, totally negating the simplification attributed to prepayment. (Mandatory prepayment would not work either, because many taxpayers of modest means would need the immediate deduction for their saving.) Even with immediate elections, the system could still be successfully gamed. Investments could be partitioned into low and high return portions, or common and preferred stock could be issued, allowing investors to make informed choices in their tax elections. In short, the Treasury would not get a random draw under prepayment. And one might just imagine the public reaction to the first highly successful prepaid investment, in light of our recent experience with safe harbor leasing.

There are apparent simplicity disadvantages to the expenditure tax. A transition to an expenditure tax would involve considerable difficulty in appropriately forgiving tax on consumption out of income already taxed under the income tax. At the same time, fairness requires taxing consumption out of income untaxed under the prior income tax regime (such as accrued but unrealized capital gains). Hoarding of cash and tax evasion over the transition period would have to be detected. The administrative burden under such a transition would be immense. All of our tax treaties with other nations would have to be renegotiated, puzzling conceptual problems would be raised, and our bargaining positions would likely be weak. Finally, the routine administration of the expenditure tax would have to be developed at considerable cost. It has been argued

that the administrative problems of the expenditure tax are no more formidable than those of the income tax. However, administration of the income tax has been learned by doing over sixty years, in part while the public sector and the yield of the income tax were both small. Leaping into the expenditure tax cold turkey with a much larger fiscal and administrative load will be costly, even though those costs may be paid in full once we accumulate an equivalent stock of expenditure tax experience.

A final complication of the expenditure tax is that borrowed money must be taxed just like wages or interest income. Absent this feature, taxpayers would be able to borrow money without tax consequences, put it in the bank, and claim a tax deduction for saving; if such maneuvering were permitted, the expenditure tax would be essentially optional. Needless to say, many taxpayers might be confused if such a provision were to appear in the tax law.

This brings us to the final (and to some observers, the crucial) criterion for judging the two tax systems: economic efficiency. The expenditure tax would reduce the tax burden on income from capital by exempting saving from tax. In so doing, it would equate the before- and after-tax rates of return on saving; under the income tax, the after-tax return is lower because income is taxed when earned and its subsequent investment return is also taxed. This leads to two advantages for the expenditure tax: first, the incentive to save is likely increased; and second, the allocation of saving and consumption over time is made more

efficient. Of the two advantages, the second seems to attract less interest from noneconomists, and so we might pay more attention to the effect of the expenditure tax on saving.

Despite the theoretical ambiguity, it seems likely that the expenditure tax would increase saving relative to an otherwise equivalent income tax; that is to say, saving would likely increase due to an increase in the after-tax rate of return.[8] However, the magnitude of the increase in saving is likely to be small, and given the relatively limited role of personal cash saving in total U.S. capital formation, the effect on the size of the capital stock is likely to be quite small.[9] There may also be offsetting efficiency losses. To the extent that the tax burden on income from capital is decreased, the tax burden on income from labor must increase if an equal or greater revenue yield is to be achieved. This would lead to possible reductions in labor supply. The manifestation of this shift in tax burdens would be the higher marginal tax rates under an expenditure tax. For the same degree of leakage from the tax base, the expenditure tax, with its deduction for saving, would require higher marginal rates. Thus, income that is received and consumed currently, typically income from labor, would be taxed at higher rates.

Not only is the effect of the expenditure tax on saving highly uncertain, but saving behavior under the current tax law is not well understood. Data are extremely sparse and inexact.[10] Thus, the proper tax rate schedule for a new expenditure tax would be difficult to

determine, with error likely on both the distribution and the yield of the tax relative to what was intended. Some income groups will likely receive unintended tax cuts or face unintended tax increases, and the federal government could easily impose a "fiscal surprise" shock on the economy by miscalculating the revenue yield of the tax.

Finally, the expenditure tax has a theoretical advantage in its handling of inflation. Because consumption is a current concept, the expenditure tax base would need no adjustment for inflation. If the expenditure tax had graduated rates and relief for low expenditure taxpayers, it would still require bracket and exemption indexing to be fully inflation proof; but that would be much simpler than indexing the tax base. The inherently current expenditure tax base also eliminates the need for measurement of depreciation, a complication under the income tax.

To summarize, the choice between the expenditure tax and the income tax on efficiency grounds is probably a close call. The expenditure tax has benefits in its treatment of income from capital, but its concomitant increase in taxes on labor income must be considered in determining the overall welfare gain or loss. Likewise, with respect to fairness, the expenditure tax has the attractive quality of equal taxes on equal lifetime expenditure streams; but there are reasons to question the importance of that attribute, and other questions might be asked about accumulations of wealth. Policymakers who have to choose between the two tax systems might be swayed by the imponderables of transition to and administration of a totally different tax system.

So before we either snap up the expenditure tax or reject it out of hand, we should consider other options for the income tax itself.

INDEXING?

The rapid inflation of the past decade has significantly distorted the operation of the tax system. Real tax liabilities have increased through years of slow growth and high unemployment, because inflation eroded the value of the personal exemption and zero bracket amount (formerly the standard deduction) and pushed taxpayers into higher marginal rate brackets. ERTA solved this problem by indexing the exemptions and the tax brackets (including the zero bracket), but indexing does not begin until 1985 (after the scheduled tax rate cuts are completed).

However, a potentially more serious problem remains. The amounts of income to be taxed are themselves distorted by inflation, in that dollar-denominated assets and liabilities depreciate in real terms when the price level rises. Thus, a 10 percent bond yields only 2 percent real interest during 8 percent inflation; with a 50 percent nominal tax rate, the real rate of tax is a confiscatory 250 percent. Mere tax rate indexing barely makes a dent in this problem. The solution is indexing the tax base: allowing the depreciation of assets due to inflation to be deducted from taxable income, and including the depreciation of liabilities in taxable income. Realized capital gains on assets with variable nominal values would also be indexed. These steps would eliminate the taxation of income that represented only compensation for inflation, and

would initiate the taxation of inflation's improvement of the real net worth of debtors. We might expect real interest rates to become more stable, because the risk of confiscatory real tax rates would be eliminated. The incentive to save might be increased for the same reason.

Of course, indexing's beneficial effects are not free. Indexing the tax base would require some extraordinarily complex changes in the tax code.[11] (For example: What would be the correct inflation adjustment on the sale of a home that had been financed with a mortgage loan? Only the seller's equity in the home should be indexed, but that equity changed continuously as the mortgage loan was amortized.) There would be further compliance and cash management problems for taxpayers. Until the inflation statistics were compiled, taxpayers would be uncertain of the tax liabilities on the income from their investments. Debtors would have to pay tax on the depreciation of their liabilities without a corresponding cash receipt from which to pay the tax. Leveraged investors might seek indexed incomes to assure themselves of cash to pay the tax on the depreciation of their liabilities if inflation accelerates. Thus, indexing the tax code might lead to further indexation of a broad range of financial transactions, causing a rapid transmission of inflationary shocks throughout the economy. Such a development would make inflation harder to stop.[12] Finally, the nominal and real revenue impact of tax base indexing would be extremely difficult to predict, because ostensibly offsetting inflation adjustments to borrowers and lenders might in fact move taxable income from high to low tax rate brackets or vice versa. Thus,

the government's finances would be less predictable. The distribution of the tax burden could be drastically reshuffled, leaving many taxpayers with quite different liabilities than they had expected and upon which they had planned.

The current budget outlook raises other questions about ERTA's tax rate indexing. With burgeoning deficits predicted for 1985 and beyond, some tax experts have called for the repeal of indexing to help narrow the gap. Others who value indexing highly have proposed retaining indexing, or even starting it sooner, while repealing some of the scheduled rate cuts or raising taxes in other ways.

Both tax rate and tax base indexing are controversial, and are likely to remain so. Continued progress in reducing inflation might set back the drive for indexing, while more rapid inflation will surely give it even greater impetus.

A FLAT RATE INCOME TAX?

Probably the most frequently mentioned alternative to the current income tax is a flat rate system -- the use of a single marginal tax rate. Obviously, one could institute a flat rate while doing nothing else whatsoever to the tax system, but most flat rate proposals include some broadening of the tax base to allow a lower marginal rate.

The rationale for the flat rate tax can spring from the most fundamental notions of fairness. The progressive income tax is based on the concept of ability to pay, according to which taxpayers with higher incomes should contribute greater shares of their incomes in taxes.

However, some tax analysts as well as interested laymen argue that taxing everyone's income at the same rate is more fair than favoring some taxpayers with lower rates than others. Blum and Kalven, in their classic, The Uneasy Case for Progressive Taxation, argue against progressive rates on a number of grounds and seem to view a flat rate tax with more favor.[13]

One could find more pragmatic advantages for a flat rate, especially in the current context. With virtually all taxpayers facing the same marginal rate, there would be no incentive to shelter income by artificially moving it from high- to low-bracket taxpayers. Taxpayers who are consistently taxable could not profit by timing their realizations of income to years when they are in the low tax rate brackets. The marriage penalty could be eliminated. And finally, the flat rate tax would have no "bracket creep" as such, and so it would be less senstitive to inflation than a tax with progressive rates.

Two distinct types of flat rate taxes have been proposed. The first is a gross income tax -- that is, a flat rate tax on gross income[14] without exemptions or deductions of any kind. The reasoning behind the gross income tax is that the marginal tax rate can be made so low with a broad tax base that no low income relief is needed. System 1 in Table 1 shows the effect on tax liabilities by income class of a gross income tax on AGI (including capital gains in full) yielding the equivalent of 1984 law tax revenues at 1981 income levels. The marginal (and average) tax rate needed is 11.8 percent. As is obvious from the table, the gross income

tax is starkly redistributive, increasing taxes for every income class below $30,000 and decreasing taxes for every class above. The tax reduction for the income class above $200,000 is 53.2 percent, while the tax increase at the $15,000 to $20,000 level is 28.8 percent or over $450 per return. If these low income taxpayers were to be held harmless by a mechanism outside of the tax system, it would require a sizeable increase in the present income support system of means tests and caseworkers. If the tax system itself is to be used to reduce this added burden on the lowest income groups, then some form of low income relief must be introduced.

The other three flat rate tax systems in Table 1 show how the introduction of low income relief would alter the outcomes. System 2 demonstrates a change to a flat rate with the remainder of the 1984 tax law unaltered. The results suggest why most flat rate proposals specify a broadening of the tax base; the tax rate required, at 18.5 percent, is much higher than that of the gross income tax using the broader base. Because the flat rate in this context is a straightforward rate increase for low income taxpayers and rate cut for upper-income taxpayers, the distributional result is not in doubt; taxes are increased by 30.0 percent at the $15,000-$20,000 income level, and cut by 56.5 percent at over $200,000 of income. Nonetheless, the introduction of low income relief does make the system progressive, in contrast to the gross income tax.

One approach to reducing both the required marginal tax rate and the redistributional effect of the flat rate tax is to broaden the tax base. Pulling some of the well-to-do's tax exempt income into the tax base raises their liabilities and reduces the required marginal rate, thereby lightening the load of those with lower incomes. System 3 illustrates the effect of broadening the tax base by taxing long-term capital gains in full and prohibiting itemized deductions. The tax rate required to reach 1984 law revenues is reduced to 15.7 percent, but the redistributive effect of System 2 is only partially offset. The tax increase in the $15,000 to $20,000 income class is 19.0 percent, or over $300 per return; the tax cut over $200,000 of income remains substantial at 38.7 percent, or almost $39,000 per return. It would be possible to broaden the tax base still further, but System 3 probably encompasses the bulk of the potential base broadening. Thus, any further neutralizing of the redistributive effects of the flat rate tax would have to come from expanding the low income relief.

System 4 uses the same broadened tax base as System 3, but increases low income relief significantly; the personal exemption is increased from $1,000 to $1,500, and the zero bracket amounts are increased from $2,300 to $3,000 for single taxpayers, and from $3,400 to $6,000 for joint returns. The added low income relief further mitigates but does not solve the redistribution problem. The expanded exemptions and zero bracket amounts do reduce tax liabilities for some low-income taxpayers, but they also require a higher marginal tax rate, in this case 18.7

percent. Taxpayers above $50,000 of expanded income still receive tax cuts on average, with those over $200,000 saving 27.7 percent or almost $28,000 per return. Tax increases on average are faced by taxpayers with expanded incomes from $10,000 to $50,000. At the comparatively modest $15,000 to $20,000 income level, tax increases average about $125, or 7.7 percent of 1984 law tax liability, while in the $20,000 to $30,000 income class the tax increases are 9.3 percent, or almost $250 per return.

This redistributive effect of increasing low income relief under a flat rate tax has a simple intuitive explanation. Increasing the amount of income that can be received without tax reduces the tax burden on the lowest income taxpayers. At the same time, the flat tax rate is still lower than the current average effective tax rate of the highest income taxpayers, and so they get tax cuts too. With tax cuts for the top and the bottom, it is the middle that is left holding the bag. In comparing System 4 with System 3, the more generous low income relief in system 4 exempts a family of 4 with incomes up to $12,000 from taxation, compared to $7,400 under System 3. However, the higher tax rate wipes out this advantage for the family of 4 at about $36,000 of income, and families with that comparatively modest income were already facing tax increases under System 3. Above the $50,000 income level the flat tax rate still allows tax cuts compared to the 1984 tax law. There is no way to fine-tune these effects out of the system, because there are only two dials to turn -- the flat rate and the amount of low income relief -- and they afford little flexibility, especially when a revenue contraint is imposed.

How much of a problem is this inherent redistributive effect of the flat rate tax? There are probably as many opinions on the proper degree of progressivity of the tax system as there are taxpayers. As was noted above, some people believe that the flat rate is a fair, equal proportional sharing of the tax burden, and let the liabilities fall where they may. Others might want more progressivity than any flat rate system could give. But there is one benchmark that the uncommitted would likely want to consider, and that is how tax liabilties are distributed now.

Table 1 suggests that a flat rate income tax, however it is constructed and with no more than 1984 law yield, would impose a larger share of the tax burden on middle-income taxpayers. If (as was suggested at the outset) a revision of the individual income tax at this time would likely raise additional revenues, middle-income taxpayers would not only bear the entire tax increase, but also make up the difference for the substantial tax cut for those with higher incomes. Further, the figures in Table 1 show the average tax increases for the middle-income groups, but obviously some taxpayers would face larger tax increases than others. Taxpayers who lose their itemized deductions (including mortgage and auto loan interest and property taxes) in the base broadening process would have the largest tax increases, and that group would include many homeowners who have much of their household budget contractually committed to mortgage and automobile payments. Such households would likely find the adjustment to higher tax liabilities difficult.

Another perspective on the redistribution of the tax liabilities in System 4 can be seen by combining its tax changes with those of the Economic Recovery Tax Act of 1981 (ERTA). It has been argued that ERTA's tax cuts were equitable because they averaged the same percentage (about 23 percent) in all income groups. If System 4 is combined with ERTA, however, the tax cuts relative to pre-ERTA law are between 18 and 20 percent for the $15,000 to $50,000 groups, but about 30 percent for the $50,000 to $100,000 group, 40 percent for the $100,000 to $200,000 category, and almost 44 percent for those with over $200,000 of income.

This redistributive effect could be moderated by increasing the low-income relief still farther, and raising the tax rate to make up for the revenue loss. However, such a change might make the flat rate less attractive. If all taxpayers faced a flat rate of perhaps 20 percent, the combined marginal tax rate on labor (including the social security payroll tax and state and local income taxes) might exceed 30 percent for most taxpayers. This would be an increase for many low wage workers.

Of course, the distributional effects of a tax policy change do not have veto power, and the benefits of the flat rate tax in terms of greater simplicity are significant. How much of these benefits would we have to give up to reduce the redistributional effects?

OLD FASHIONED TAX REFORM?

To this point, we have examined several alternative futures for the individual income tax. The purposes of these alternatives have been to simplify the tax system, reduce or eliminate the sensitivity of the tax

rates or base to inflation, reduce disincentives to work, saving, and investment, broaden the tax base, reduce horizontal inequities, and discourage the gaming of the tax system. Each of the options discussed requires a leap of faith -- the expenditure tax would raise considerable and to some extent still unknown administrative and distributional issues; indexing the income tax base would drastically reshuffle tax liabilities and alter borrower-creditor relationships; and the flat rate tax would systematically shift a greater share of the tax burden to the median voter. The traditional inertia of our tax-writing process would suggest that these options are longshots, although the recent rather adventurous adoption of the 5-10-10 tax cut, and the current dire budgetary situation, might lead us to reconsider the odds.

We might also throw into the hopper a least common denominator solution: good old fashioned tax reform. If the Congress will broaden the tax base for the expenditure tax or the flat rate income tax, perhaps it will do so for the progressive income tax. To descend to an institutional plug: the Congressional Budget Office enumerated 40 possible base broadening steps in Reducing the Federal Deficit: Strategies and Options earlier this year, and there are surely many more base broadeners waiting in the wings. Advocates of flat rate or expenditure taxation suggest that their strategy of surprise, in which a totally new and different tax system is sprung on the nation's tax lobbyists, is the best shot at cleansing the tax base. They may be right. But then again, they may be wrong.

Base broadening under the progressive income tax would split the difference between the status quo and the conceptually more ambitious options on many of the tax policy goals. With base broadeners such as those suggested by CBO and others, the tax rate schedule could be lowered and flattened. To suggest orders of magnitude, a 14 percent first bracket rate with low income relief would closely mirror the distribution of the 1984 tax law up to about the $40,000 income level. That would, in effect, give about 75 percent of all taxpayers a flat rate tax without redistributing income. Above that income level, a small number of additional tax brackets, perhaps 3, would be needed to keep the distribution of tax liabilities approximately constant, with the highest tax rate under 30 percent. Such a tax system would approach the flat rate tax in simplicity, though some of the multi-bracket problems would remain. It would have a lower marginal tax rate for most taxpayers, but would require a slightly higher maximum rate. Bracket creep would not be eliminated as in the flat rate tax, but it would be significantly reduced. There would be a marriage penalty, but it would probably be less than half of that under current law, even without a special deduction. Finally, it would be possible to achieve the marginal rates stated above without elimination of the basic homeowner deductions (mortgage interest and property taxes); this would leave some of the complication in the tax code but would cause fewer taxpayers to face tax increases than would eliminating itemized deductions entirely.

In terms of economic efficiency, the broad-based progressive income tax would be comparable to the expenditure tax. The marginal tax rate on income consumed currently would be lower under the broad-based income tax than under the expenditure tax. Income from capital would continue to be double taxed under the broad-based income tax, but at lower marginal rates than under the expenditure tax, and so the ultimate incentives to save might not be very different. The lower marginal tax rates would reduce (but not eliminate) the overtaxation of income from capital due to inflation, and the lower and flatter rate schedule would make market interest rate adjustments more effective in offsetting the rest of inflation's redistributive effects.[15]

What the broad-based progressive income tax lacks is conceptual purity: it does not offer a single tax rate, total inflation neutrality, or complete optimality in the treatment of saving. On the other hand, it is simple, operationally close to the system we already know and understand, would not drastically redistribute tax liabilities compared to current law, and moves in the right direction on virtually every criterion.

In a legislative atmosphere of frantic activity and unbounded uncertainty, improving the tax system has as good a shot as anything else. It would be a shame if the advocates of simplicity, efficiency, and fairness came away empty handed for lack of trying, but from the looks of the program for this symposium, the interest and the effort are here.

TABLE 1. DISTRIBUTION OF TAX LIABILITIES UNDER ALTERNATIVE FLAT RATE TAX SYSTEMS COMPARED TO 1984 TAX LAW[a] AT 1981 INCOME LEVELS

Expanded Income (thousands)	Number of Taxable Returns (thousands)	Tax Liability 1984 Law (millions)	System 1			System 2			System 3			System 4		
			Tax Liability (millions)	Change (Percent)	Change (Dollars Per Return)	Tax Liability (millions)	Change (Percent)	Change (Dollars Per Return)	Tax Liability (millions)	Change (Percent)	Change (Dollars Per Return)	Tax Liability (millions)	Change (Percent)	Change (Dollars Per Return)
< 5	6,482	403	5,479	1,259.5	783.07	1,574	290.7	180.71	2,232	453.7	282.10	1,996	395.2	245.71
5- 10	15,057	5,772	14,280	147.4	565.04	8,752	51.6	197.91	7,854	36.1	138.26	5,345	-7.4	-28.33
10- 15	13,092	12,526	19,700	57.3	547.99	17,610	40.6	388.31	15,720	25.5	243.97	12,698	1.4	13.11
15- 20	10,737	17,462	22,496	28.8	468.88	22,665	30.0	484.54	20,778	19.0	308.88	18,802	7.7	124.76
20- 30	16,800	44,080	49,701	12.8	334.58	52,871	19.9	523.28	49,978	13.4	351.06	48,170	9.3	243.45
30- 50	13,568	63,833	60,579	-5.1	-239.82	66,419	4.1	190.61	66,466	4.1	194.08	68,804	7.8	366.41
50-100	3,580	38,687	27,389	-29.2	-3,155.74	30,486	-21.2	-2,290.90	32,658	-15.6	-1,684.20	36,104	-6.7	-721.60
100-200	631	18,656	9,872	-47.1	-13,920.58	10,743	-42.4	-16,540.20	12,459	-33.2	-9,821.59	14,344	-23.1	-6,833.56
200 <	164	16,385	7,675	-53.2	-53,107.15	7,129	-56.5	-56,438.05	10,050	-38.7	-38,630.67	11,843	-27.7	-27,692.33
Total	80,110	217,803	217,172	-0.3	-7.87	218,249	0.2	3.57	218,194	0.2	4.88	218,106	0.1	3.78

SOURCE: Joint Committee on Taxation.

System 1: 11.8 percent tax on adjusted gross income with long-term capital gains included in full.

System 2: 18.5 percent tax on 1984 law taxable income less zero bracket amount.

System 3: 15.7 percent tax on 1984 law taxable income less zero bracket amount, with long-term capital gains included in full, and no itemized deductions.

System 4: 18.7 percent tax on taxable income as in system 3 with increased exemption and zero bracket amount.

a. To facilitate comparison, 1984 law does not include the earned income credit, the two-earner couple deduction, or the IRA or Keogh provisions. The flat rate tax systems similarly do not include those provisions.

b. Outcomes under the flat-rate tax for tax returns of under $5,000 of income would be highly uncertain. Some taxpayers at that income level currently make use of tax preferences that would be terminated under the flat-rate tax, and those taxpayers would thus face substantial tax increases. A particular problem would arise under System 1, in which all income would be subject to tax without exemption or deduction; many households with very low incomes who are excused from filing tax returns under the 1984 law are therefore not represented in the table, but would have to file returns and pay taxes under System 1. The impact of this factor on the table would likely be small, though it would significantly change administrative burdens under the tax systems.

FOOTNOTES

1. Nicholas Kaldor [1955]. Kaldor quotes Fisher, Pigou, and Hobbes as supporters of the expenditure tax concept.

2. William D. Andrews [1974] originated the cash flow approach to expenditure taxation discussed here.

3. This discussion relies on U. S. Department of the Treasury [1977] and David F. Bradford [1980].

4. This discussion follows Richard Goode [1980].

5. A highly detailed discussion is provided by Michael J. Graetz [1980]; see also Sven-Olof Lodin [1980] and Paul R. McDaniel [1980].

6. U. S. Department of the Treasury [1977].

7. As explained by Graetz [1980] and Alvin C. Warren, Jr. [1980].

8. The research of E. Philip Howrey and Saul H. Hymans [1980], and comments by Michael J. Boskin [1980] and John A. Brittain [1980], indicate considerable uncertainty as to the exact elasticity of saving to the real after tax rate of return, but suggest that it is likely positive and small.

9. Assuming a 30 percent increase in the real after tax rate of return due to the changeover to an expenditure tax, and further assuming a 0.2 elasticity of saving to that rate of return, personal saving would increase by 6 percent, or at 1981 levels from $106.6 billion to $113.0 billion. However, that $6.4 billion increase would add only 1.3 percent to the actual $477.6 billion to total private saving.

10. Recent data are presented in U. S. Department of Labor [1978a] and [1978b]. However, these data are from a relatively small random sampling of the population, and thus include relatively few of the upper income households who are thought to do most of the saving. Total saving in these surveys seems to be roughly consistent with national accounts data, but conceptual differences prevent any definitive comparison.

FOOTNOTES
(continued)

11. This discussion relies on research presented in Henry J. Aaron [1976].

12. Arthur M. Okun [1981], chapter 7.

13. Walter J. Blum and Harry Kalven, Jr. [1953].

14. By "gross income" is meant a concept approximating adjusted gross income in the current income tax, which is the sum of numerous income components, some of which are "net" -- e.g. net partnership income, net rental income, etc. It is not meant to suggest some measure of gross receipts, in which total business receipts would be included with no deduction for business expenses such as wages, cost of goods sold, etc.

15. If all taxpayers were subject to the same marginal tax rate during inflation, market interest rates could increase so as to hold constant both the real after-tax interest incomes of lenders and the real after-tax interest expenses of borrowers. See Tanzi [1980], chapters 10 and 11. While a system with more than one marginal tax rate (not to mention some nontaxable borrowers and lenders) prevents such a precise market adjustment, the broad-based income tax system with a flatter rate schedule would allow a more precise adjustment than the current income tax.

REFERENCES

Henry J. Aaron, editor, Inflation and the Income Tax (Washington: The Brookings Institution, 1976).

William D. Andrews, "A Consumption-Type of Cash Flow Personal Income Tax," Harvard Law Review, vol. 87 (April 1974), pp. 1113-88.

Walter J. Blum and Harry Kalven, Jr., The Uneasy Case for Progressive Taxation (Chicago: University of Chicago Press, 1953).

Michael J. Boskin, "Comments" in Joseph A. Pechman, editor, What Should Be Taxed: Income or Expenditure? (Washington: The Brookings Institution, 1980).

David F. Bradford, "The Case for a Personal Consumption Tax," in Joseph A. Pechman, editor, What Should be Taxed.

John A. Brittain, "Comments," in Joseph A. Pechman, editor, What Should Be Taxed.

Richard Goode, "The Superiority of the Income Tax," in Joseph A. Pechman, editor, What Should Be Taxed.

Michael J. Graetz, "Expenditure Tax Design," in Joseph A. Pechman, editor, What Should Be Taxed.

E. Philip Howrey and Saul H. Hymans, "The Measurement and Determination of Loanable Funds Saving," in Joseph A. Pechman, editor, What Should Be Taxed.

Nicholas Kaldor, An Expenditure Tax (London: Allen and Unwin, 1955; Westport, Conn.: Greenwood Press, 1977).

Sven-Olof Lodin, "Comments," in Joseph A. Pechman, editor, What Should Be Taxed.

Paul R. McDaniel, "Comments," in Joseph A. Pechman, editor, What Should Be Taxed.

Arthur M. Okun, Prices and Quantities: A Macroeconomic Analysis (Washington: The Brookings Institution, 1981).

REFERENCES
(Continued)

Vito Tanzi, Inflation and the Personal Income Tax: An International Perspective (Cambridge: Cambridge University Press, 1980).

U.S. Department of Labor, Consumer Expenditure Survey: Integrated Diary and Interview Survey Data, 1972-73, Bulletin 1992 (Washington: Government Printing Office, 1978a).

U.S. Department of Labor, Consumer Expenditure Survey: Interview Survey, 1972-73, vol. 1, Bulletin 1997 (Washington: Government Printing Office, 1978b).

U.S. Department of the Treasury, Blueprints for Basic Tax Reform (Washington: Government Printing Office, 1977).

Alvin C. Warren, Jr., "Comments," in Joseph A. Pechman, editor, What Should Be Taxed.